VZCZCXRO6167
OO RUEHLH RUEHPW
DE RUEHIL #2830/01 3271557
ZNY CCCCC ZZH
O 231557Z NOV 09
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC IMMEDIATE 6118
INFO RUEHBUL/AMEMBASSY KABUL PRIORITY 1199
RUEHLO/AMEMBASSY LONDON PRIORITY 1852
RUEHNE/AMEMBASSY NEW DELHI PRIORITY 5790
RUEHKP/AMCONSUL KARACHI PRIORITY 2593
RUEHLH/AMCONSUL LAHORE PRIORITY 8193
RUEHPW/AMCONSUL PESHAWAR PRIORITY 7240
RUEAIIA/CIA WASHINGTON DC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC PRIORITY
RHEBAAA/DEPT OF ENERGY WASHINGTON DC PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY
RUEKJCS/JOINT STAFF WASHINGTON DC PRIORITY
RHEHNSC/NSC WASHINGTON DC PRIORITY
RUEKJCS/SECDEF WASHINGTON DC PRIORITY
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL PRIORITY
RHMFISS/CDR USCENTCOM MACDILL AFB FL PRIORITY

C O N F I D E N T I A L SECTION 01 OF 04 ISLAMABAD 002830

SIPDIS

E.O. 12958: DECL: 11/18/2019
TAGS: ECON EFIN EAID PGOV PREL PK
SUBJECT: PAKISTAN'S THIRD IMF REVIEW - ENOUGH PROGRESS TO
SQUEAK BY? PROBLEMS STILL LIE AHEAD

REF: A. ISLAMABAD 1137
¶B. ISLAMABAD 1992
¶C. ISLAMABAD 2829

Classified By: Ambassador Anne W. Patterson for reasons 1.4 (b) and (d)
.

¶1. (C) Summary: In an upbeat meeting November 17, Acting Additional Secretary of Finance Salim Sethi assured Treasury Attache and Econ Counselor that Pakistan's third review under its Stand-By Arrangement with the International Monetary Fund (IMF) was "virtually assured" of a successful conclusion. Sethi asserted that the Federal Board of Revenue's willingness to raise additional revenue, through a hike in regulatory duties on luxury goods if necessary, and a meeting that reached general agreement among Government of Pakistan federal and provincial-level officials on imposition of a value-added tax were sufficient to address Fund concerns over revenue shortfalls and a dearth of reform in the tax structures. However, although he said he was confident the recommendation would be positive, Sethi admitted that Fund representatives were referring this "new information" back to IMF headquarters before making their final recommendation to their Board whether to move ahead with Pakistan's fourth disbursement of $1.2 billion. In separate meetings in Karachi, commercial bank CEOs told Treasury Attache they were seriously concerned about deficit financing by the government through an unending issuance of government paper. End Summary.

Targets Missed

¶2. (SBU) In a November 17 meeting, Acting Additional Secretary of Finance Salim Sethi gave Econ Counselor and Treasury Attache an optimistic readout of Pakistan's third review under its IMF Stand-By Arrangement (SBA) held November 2-12 in Dubai. Nevertheless, Sethi was clear that Pakistan had missed its revenue target for the quarter by approximately $92 million. Combining this shortfall with higher than planned expenditures (due to ongoing military operations and continuing subsidies on energy) meant that Pakistan's fiscal deficit was 5.3 percent of GDP vice the target of 4.9 percent.

¶3. (C) While Sethi said that breaching the deficit target

would normally have been a deal breaker for the SBA, the GOP was able to present the Fund team both mitigating circumstances and a plan to improve its balance sheet. The GOP cited higher than budgeted expenses for security (some $780 million) and lower than projected inflows from donors and the domestic tax base. The Ministry of Finance had built some $2.4 billion into the budget based on Tokyo pledges; Sethi claimed that has been reduced to $1.8 billion after consultation with the IMF and donors. Sethi said that the Japanese had been a particular disappointment: the GOP has concluded that none of the $1 billion Japan pledged in Tokyo was actually new money, but was rather $500 million of repackaged existing program funds for each of two consecutive years. Indeed, seven of the Tokyo donor countries are also repackaging existing disbursements between grants and soft loans, totaling over $1.9 billion, according to the Ministry of Finance. (Comment: Post has not yet been able to confirm the Ministry of Finance's data and assertions on donor pledges. End Comment.) Restructuring at the Federal Board of Revenue (FBR) had seriously damaged morale there, leading in turn to low tax collection rates.

¶4. (C) However, Sethi said that higher collection figures for October, which came out during the review, had mitigated some of the Fund's concern that Pakistan would be unable to make up the collection shortfall in subsequent quarters. Sethi said that the Finance Ministry had committed to raising $192 million through a series of random audits of major corporations in order to increase tax revenue and would offer incentives to tax collectors to induce them to improve their

performance. These measures would be combined with "small cuts" to the development budget. If all else fails, Sethi said the GOP is prepared to raise the regulatory duties on luxury imports in order to ensure sufficient revenue.

¶5. (SBU) Sethi said that the GOP is retiring some $599 million in loans being held by the State Bank of Pakistan (SBP), which would also help the GOP's balance sheet. He proudly announced that he had orchestrated disbursement of some $400 million in loans from the Asian Development Bank (ADB), that had been languishing when the responsible GOP agencies, for a variety of reasons, were not able to fulfill the necessary criteria - most of which was paperwork formalizing ADB guidelines the GOP had already informally accepted. This would largely cover some $600 million in Sukuks that the GOP must retire in February, and would justify the 1.7 percent fee Pakistan is paying to hold onto undisbursed IFI funds (Note: Sukuk is an Islamic finance instrument, similar to more common government bond, that complies with Sharia law. Because trading in debt is prohibited under Sharia Law, the issuer of a sukuk sells the certificate to an investor who then rents it back to the issuer for a predetermined rental fee. End Note).

Last Minute Steps on Tax Reform

¶6. (C) Sethi confirmed that the Fund is concerned with a lack of progress reforming Pakistan's tax structures. Plans to consolidate the administrative functions of the Sales Tax/Customs and Excise branch with those of the Income Tax branch at the FBR had gone awry several months ago when Customs officers (traditionally appointed from those higher up the rankings of the Civil Service) went to court in order to escape being lumped together with their lower-ranked brethren (Ref A). Although the GOP managed to establish the Inland Revenue Service on paper September 15, the actual consolidation of staff and functions remains blocked in the courts, according to the World Bank, who have the lead among donors assisting the GOP with tax reform. Legislation harmonizing the income and sales tax laws has been drafted, but is currently still sitting in the Ministry of Law. Sethi further explained that questions about the leadership, "administrative challenges," and the overall mission of the

FBR seriously hurt morale in the organization.
¶7. (C) At the Bank's recommendation, the GOP had separated tax policy and tax implementation functions; the Secretary Finance became the head of Inland Revenue and responsible for devising tax policy, and the Chairman FBR was charged with implementing that policy. Sethi called this a "disaster" for Pakistan's tax policy, despite the skill and good intentions of the two officials. He said the move had "gutted" the Chairman's authority at the FBR, leaving him unable to either properly discipline or reward staff; hence the poor collection rates in the first quarter. However, Sethi claimed that decision had been reversed in Dubai and the Chairman's authority restored. Sethi said this move was taken to ensure that the Chairman is able to carry out effectively the incentives/audit plan to which the GOP committed for revenue generation.

¶8. (SBU) More positively, Sethi said that the GOP had held a conference on establishing a value-added tax (VAT) in Dubai on the margins of the IMF review. Originally planned for July, then repeatedly postponed (largely for logistical and security reasons, according to organizers at the World Bank), the conference is an essential first step in bringing on board all parties who must concur with the mechanics of implementing the VAT. Sethi called the conference a success, adding that provincial finance ministers and federal officials had largely agreed to accept a formula in line with the National Finance Commission (NFC) as the basis upon which to distribute receipts among the provinces, and between the provinces and the federal government.

A Role for Overseas Pakistanis

¶9. (SBU) Sethi opined that the GOP does not have a plan to encourage overseas Pakistanis to invest in Pakistan. He called the notable increase in remittances temporary, in that it is uncertainty in the U.S. and European economies (from where the majority of the increase in remittances is coming) that is causing overseas Pakistanis to send more money home. Sethi recommended that the GOP develop initiatives to encourage overseas workers to consistently send more money home, regardless of prevailing economic conditions.

Borrowing from Banks a Problem

¶10. (SBU) While the Government continues to retire debt to the State Bank of Pakistan (SBP) in scheduled periods, government borrowing from commercial (or "scheduled") banks for budgetary support increased 44 percent in the past three months, leaving total government paper held by the banks at $1.6 billion in early-November. Bank CEOs from over a dozen commercial banks explained to Treasury Attache in early November that, for this reason, their intent is to limit their exposure to the private sector for the foreseeable future. The banks have serious concerns about the credit worthiness of new customers and are worried about increasing potentially non-performing loans on their balance sheets. Consequently, the availability of loanable funds among the banks, and generous interest rates, permitted the government to easily increase its deficit financing through commercial banks.

¶11. (C) Although the banks were somewhat content with the current situation, several of the CEOs felt there were serious problems for them and the government if the situation did not change. Nearly all of the bankers believed that the government was financing a significant portion of the war in the FATA through the issuance of government paper. None of them felt that the current conflict would be over shortly, and the longer the war dragged on the more stress it would put on them and the government. The CEO of Habib Bank Limited, Zakir Mahmood, commented he was "saturated with

government paper," and complained of a "culture of deficit financing" within the government. While he believed individuals such as Finance Minister Shaukat Tarin and State Bank Governor Salim Raza saw the risks, he had a much lower opinion of other senior GOP officials.

¶12. (C) The CEOs of United Bank Limited and KASB Bank, Atif Bukhari and Muneer Kamal, explained the conundrum for the government should the economy improve: they would begin to offload the government paper and begin to do more consumer lending. They felt somewhat confident this should not present a problem for the government provided the FBR could make up the difference in tax revenues, and neither believed consumer lending would improve before the end of the fiscal year. Deputy State Bank Governor Yaseen Anwar echoed the concerns of the commercial bankers, and confided he also felt that some senior officials in the government did not have a sense of fiscal discipline. Several members of Anwar's staff said they were seriously concerned that the government's flat revenue generation coupled with the steady increase in deficit financing presented a big problem in the months ahead. Zakir Mahmood was even more pointed, commenting this was setting up a "perfect storm" in the economy if revenue did not pick up.

¶13. (C) Comment: Senior Economist at the World Bank Hanid Mukhtar predicts that, even in the unlikely event that GOP revenue projections for the next three quarters are met fully, GOP expenditures will also pick up momentum - quite apart from the cost of military operations - as the fiscal year unfolds. Despite a first quarter improvement in the performance of the manufacturing sector (Ref C), as the cash cow from which the GOP derives the majority of its revenue, even more improvement will be essential to meet revenue

targets while avoiding more significant cuts in the development budget. Finally, Mukhtar pointed out that the federal government has only limited ability to curtail what he called "election year spending" by the provinces (particularly Punjab and increasingly Sindh), who then appeal to the State Bank to cover their budget shortfalls.

¶14. (C) Comment cont'd: Sethi's news about the VAT conference is welcome, as it was apparently pushed forward from its end November tentative date to respond to IMF concerns. That the parties have agreed amongst themselves on the way forward for collecting and dividing VAT receipts is also good news, except insofar as it might rely on the not-yet-fully agreed formula for National Finance Commission awards (Ref C). The schedule to implement the VAT by the end of the Pakistani fiscal year (June 30) remains ambitious nevertheless. Sethi said the Ministry is very much aware that USG assistance disbursements to several Pakistani institutions, including the Higher Education Commission (HEC) and the Benazir Income Support Program (which provides income assistance to Pakistan's poorest families), depends upon the successful conclusion of the IMF review.
PATTERSON